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FM AMEMBASSY TEL AVIV
TO RUEHC/SECSTATE WASHDC PRIORITY 2718
INFO RUEHJM/AMCONSUL JERUSALEM PRIORITY 7618
RHEHNSC/NSC WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY

C O N F I D E N T I A L TEL AVIV 002446

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E.O. 12958: DECL: 08/05/2017
TAGS: EFIN ECON MASS MCAP EAID PGOV PREL IS
SUBJECT: GOI CONSIDERS 2008 BUDGET, COALITION PARTNERS SHARPEN THEIR KNIVES

REF: A. TEL AVIV 2365
¶B. TEL AVIV 2158

Classified By: Ambassador Richard H. Jones for reasons 1.4 (b/d).

¶1. (C) SUMMARY: On August 5, the Ministry of Finance (MOF) formally presented the 2008 draft budget to the Government of Israel (GOI). Prime Minister Ehud Olmert and newly-appointed Finance Minister Roni Bar-On have made strong public statements on their commitment to maintaining fiscal discipline, and initial indications are that the budget preserves strict limits on spending. Increases for defense, education, welfare, and wages are offset by cuts to other sectors. Given the strong performance of Israel's economy, the 2008 budget is expected to lower debt and reassure investors and creditors. The GOI is already encountering strong opposition, however, from those who argue that high revenues merit increased investment in defense and social services. Chief among the critics is Labor Party leader and Minister of Defense (MOD) Ehud Barak, who will likely use the budget debate to raise his profile in preparation for future elections. Barak and others have called on the GOI to raise the expenditure limit, and it remains to be seen whether Olmert can withstand pressure from governing coalition partners and various interest groups -- including the military. MOF Director General Yarom Aviav said that in complying with loan guarantee agreements with the USG, excess revenue would be used to reduce debt. Some economists warn that a sharp increase in spending at this time could send a negative signal to markets and damage Israel economic performance. END SUMMARY.

Economic Success Creates Pressure to Spend

¶2. (C) The GOI is heading into the 2008 budget season with strong economic indicators. Despite the problems of the past year, including inter alia the inconclusive war in Lebanon, scandals at the Finance Ministry, and weak public support for the Olmert government, the BOI forecasts 5.1 percent gross domestic product (GDP) growth for 2008. The business sector is growing at a rate of 6-6.5 percent. Israel continues to register a strong current-account surplus driven by hi-tech exports and services, Deficits have declined to 1.5-2.0 percent of GDP due to a consistent period of fiscal discipline. The strength of the economy and high revenues have prompted Israel's many interest groups and political parties to advocate for increased spending. This comes at time when the economy is entering an inflationary cycle, with higher interest rates and a jittery stock market (ref A). A recent credit analysis by Standard and Poor's took the unusual step of linking Israel's credit rating to expenditure growth, warning that increased spending in 2008 could lower

Israel's favorable score.

¶3. (C) The MOF budget proposal maintains a 1.7 percent ceiling on expenditure growth, designed to reduce the debt-to-GDP ratio to 82 percent in 2008. The total budget is calculated at NIS 311.6 billion (USD 72.47 billion) including a 1.6 percent deficit. Despite increased spending in some sectors, the MOF took a firm stand on controlling expenditures with proposed cuts worth NIS 6 billion (USD 1.39 billion). Michal Finkelstein, Chief of Staff to the MOF Director General, explained to Econoff and visiting Treasury Department International Economist Michael Hirson that the GOI will officially consider approval of the MOF's draft budget on August 12, after which it will be presented to the Knesset. Despite the inevitable negotiations involved in this process, Finkelstein insisted that Olmert and Bar-On have no intention of loosening the purse-strings.

¶4. (C) Gil Bufman, Senior Vice President and Chief Economist for Bank Leumi, was more skeptical on this point. In a meeting with Hirson and Econoff, Bufman said that given increased security concerns and the weakness of the current government, he expected the spending ceiling to increase to 2.2 percent. He was doubtful that Bar-On, with little experience in economics, would be an effective force for fiscal restraint. Bufman noted that to some extent, the MOF had already relaxed fiscal discipline by choosing a relatively optimistic revenue forecast of 4.2 percent as the basis for budget calculations, leaving little room for a positive surprise in revenues. In contrast, MOF calculated the 2007 budget based on 3.8 percent growth -- at the low end of economic estimates. Aviav told EconCouns that excess revenue is intended to reduce the debt-to-GDP ratio.

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Pressures on Expenditures: Military First in Line
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¶5. (C) MOD demands for increased funding are a normal occurrence in the Israeli budgeting process, but recent developments -- the war in Lebanon and the appointment of a strong Minister of Defense in Barak -- give them even greater weight. The 2008 budget promises an NIS 3 billion (USD 697 million) increase in defense spending for a total of NIS 50.5 billion (USD 11.74 billion). This includes NIS 1.3 billion (USD 302 million) for implementing the recommendations of the Brodet Committee (ref B). Barak has indicated on several occasions, however, that these measures are insufficient to improve the preparedness of the Israel Defense Forces, and demanded an additional NIS 6 billion (USD 1.4 billion) for ¶2008. The details of the defense budget remain largely opaque, involving various manipulations of future budgets, expenditures conditioned on arms sales, and the expected flow of FMF assistance from the United States. Some items remain entirely off-budget, including one-time expenditures of NIS 2.2 billion (USD 511 million) for the Lebanon War and NIS 1.1 billion (USD 256 million) for Gaza disengagement.

¶6. (C) Dr. Michael Sorel, Chief Economist of Harel Insurance and Finance (and a former MOF official), said that surplus revenues for 2007 were used to cover these additional items while preserving the 1.7 percent ceiling. In Sorel's view, this was a responsible short-term solution to a national emergency, but in the long-term the MOD must adopt a more rational budgeting process. Karnit Flug, Director of Research at the Bank of Israel and a member of the Brodet Committee, said that the GOI will address this problem by setting aside NIS 800 million per year for emergency situations, releasable only with GOI approval. If the funds are not used by the end of the budget cycle, they are reinvested in armament or other essential security needs.

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Civilian Sectors Resist Cuts, Demand Increases
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¶7. (C) The MOF budget proposal includes a six percent budget cut across the board in all ministries. The MOF outlined

approximately NIS 6 billion (USD 1.4 billion) in specific spending cuts, to include reductions in water subsidies and reduced investment in transportation infrastructure, and proposed a service charge for housekeepers on health and social security. There are additional indications that the Prime Minister's Office will seek to postpone commitments to increase the minimum wage and improve the status of temporary workers. The cuts are expected to meet fierce resistance from Members of Knesset (MKs) when the budget reaches the Knesset, with calls for increased spending for universities, the elderly, health care, and minimum wage earners. Some groups have already engaged in highly publicized battles with the GOI over spending. Elderly holocaust survivors took to the streets August 5 in front of the Prime Minister's residence, protesting what they perceived to be a paltry government stipend (the Hebrew daily Maariv reported that the GOI will meet their demands). The Histadrut, Israel's national labor federation representing 700,000 public sector employees, launched a general strike in July, demanding a 10.4 percent wage increase retroactive to 2001. The two sides finally agreed on an increase of five percent stretching from 2005-2009, which was generally viewed as a strong showing for Bar-On. Nevertheless, the wage agreement creates additional pressure on the expenditure ceiling.

Budget Process Pits Labor v. Kadima

¶8. (C) While some sectors face cuts, the three primary ministries held by the Labor Party -- defense, social welfare, and education -- are all slated for budget increases. The MOF budget promises NIS 3 billion (USD 697 million) for education, NIS 1.9 billion (USD 442 million) for welfare, and NIS 1.6 billion (USD 372 million) for employment. (NOTE: Finkelstein made clear that the latter remains a high priority for the Prime Minister, who has promised to reduce poverty through an aggressive job creation initiative. END NOTE.) Despite these concessions, Barak and Labor are expected to offer strong opposition to the budget, both within the government and on the Knesset floor. As Defense Minister and future contender for the office of Prime Minister, Barak has staked out a position in favor of increased spending on defense and a minimum wage increase, among other issues.

¶9. (C) Much depends on Barak's brinksmanship, said Sorel, and whether he is willing to topple the government over the budget. In an August 3 column in the daily newspaper Haaretz, Yossi Verter commented that it is unlikely that Barak would force new elections over the budget, but that he would like to wrest as many concessions from Olmert as possible to improve his standing with the electorate. In Bufman's view, protracted uncertainty regarding the future of this government is worse for the markets than early elections. Investors would welcome more stable leadership, said Bufman, as the current government has been largely ineffective at implementing economic policy, and done little in the way of reform.

Debating the Expenditure Limit

¶10. (C) Sorel argued that from a strictly economic perspective, there is nothing wrong with exceeding the 1.7 percent ceiling. Several years ago, said Sorel, Israel's public expenditure as a percentage of GDP was very high. Following Likud Party leader Benjamin Netanyahu's tenure as Finance Minister, however, and successive budgets with limited expenditure increases, this is no longer the case. With 4-5 percent GDP growth, argued Sorel, the expenditure to GDP ratio is shrinking quickly and now stands at the median of OECD countries. If one takes into account Israel's disproportionately high military spending, then Israel now has one of the lowest ratios among industrialized countries. In addition, Israel now boasts low tax rates and declining

public expenditure as a percentage of GDP. In both political and economic terms, said Sorel, Israel cannot be expected to maintain the current spending limits for more than another year or two. Sorel noted that even Olmert's Chief Financial Advisor, Manuel Trajtenberg, is in favor raising the limit to 2.5 percent in 2008.

¶11. (C) The risk of increased spending is not immediate fiscal damage, said Sorel, but that once the lid is off spending will spiral out of control. According to Bufman, the markets could react quite negatively to such a decision, fearing "fiscal slippage" in the GOI's policy, the crowding out of private bonds by an increase in public debt, and a decline in Israel's credit rating. On the other hand, Sorel warned that in the long run, an overzealous adherence to expenditure ceilings can result in negative consequences for budget transparency. Over time, the GOI will shift more payments to the revenue side of the balance sheet by offering tax refunds and incentives, thereby creating distortions in real expenditure measures. The trick, said Sorel, is to increase expenditures in a rational framework that does not convey a lack of fiscal discipline to the markets.

¶12. (C) Bufman noted that over the next few years fiscal discipline will be additionally challenged on the revenue side by the absence of major privatization initiatives. The privatization of the Haifa refineries produced NIS 7 billion (USD 1.63 billion) in revenue this year, while only NIS 4.5 billion (USD 1.05 billion) is expected in revenue for the coming year, including privatization of the remaining ten percent of Bank Leumi and the Postal Bank. The GOI recently released plans to privatize other sectors, including electricity, but Bufman said this was several years off. Bufman pointed to a number of sectors in which there is a deep need for efficiencies and reform, including local government, prisons, energy, and infrastructure. He also warned that additional tax cuts promised by the government would be a further blow to revenues. "There is so much to do," said Bufman, "but this government is caught up in trying to survive."

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Comment: FMF Expectations Complicate Budget Planning
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¶13. (C) The GOI's attempts to maintain fiscal discipline and cut expenditures are ongoing, but the MOF's decision to assume USD3 billion per year in FMF funding has put its budget's credibility in doubt. GOI press leaks have already indicated that the MOD will argue that any diminution in its allocation would affect readiness and major weapons purchases. It is hard to establish a baseline for targeted military expenses since the MOD budgeting process is opaque. In the past, the GOI has found funding alternatives to budget shortfalls through increases in revenue growth and by taking big-ticket items off-budget.

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